Long-Term Investing by Pension Funds.

How to Effectively Design and Implement Mandates: a Dutch Case Study

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Abstract

Pension funds are increasingly trying to embed long-term investing choices within their portfolios. Many publications focus on the rationale for long term investing; however, it remains unclear what long term investing actually is, what sets it apart from the current way of investing, and how it should add value. The purpose of this paper is to provide a practical framework for pension fund trustees aiming to bolster and implement long term investing. In doing so, the paper's contribution is that we choose the trustee's perspective, build on different existing election and monitoring frameworks, and argue that pension boards have more instruments at hand to implement long-term investing.

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Key Words: Pension Fund, Asset Management, Investment Mandate, Long-term Investing, ESG, Investment Process, Investment Governance, Selection and Monitoring, Organizational Design

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1. Introduction

Long-term investing is about harvesting long-term risk and return sources, the effects of investments on the short or long-term behaviour of the entities being invested in, and the subsequent desired effect that has on the long-term risks and returns of the investor.

Pension funds are especially well-placed as investors with a long-term horizon. Their pension liabilities run on to the end of the century. Many pension funds have therefore made long-term thinking and sustainability part of their investment convictions. Especially in times where relatively low interest returns are expected globally, harvesting long-term return premiums is essential.

The role and long-term horizon of the financial markets has especially come under scrutiny since 2008. Investors supposedly encourage companies to focus on the short term too much. A British government committee led by Kay (2012) concluded that short-term tendencies are a problem caused by a lack of trust and perverted stimuli from the investment chain. The expert group that has advised the European Commission about sustainable financing concluded that “the relatively long-term investment horizon of end-beneficiaries with long-term liabilities (pension fund beneficiaries, household savers, sovereign wealth funds, etc.) is not reflected across the investment and lending chain, due to principal-agent concerns, as well as inadequate performance metrics and incentives” (HLEG, 2017).

Internationally, large pension funds and assets managers are collaborating in the platform “Focusing Capital on the Long Term” with the stated intention to focus asset management more on the long term. Here too, the initiative has been spurred by the observation that “shareholders and companies are in a vicious short-term circle and run from quarter to quarter.” (Andringa et al., 2015).

Whether these initiatives will have the desired result remains to be seen. Eighty percent of CFOs indicated they would cut back on research, investments, advertising and maintenance if necessary, to fulfil the short-term profit expectations of investors. More than half of the CFOs also indicated to do so at the expense of long-term value creation. 86% indicated that the financial returns of their company would be higher if they were able to focus more on the long term. This is a development that according to CFOs has worsened since the crisis of 2008 (see Graham et al., 2005, Barton and Wiseman, 2014, Haldane and Davies, 2011).

Long-term investing, and therefore sustainable investing, requires a reconsideration of the existing agreements between pension funds, the managers that they delegate their investment strategies to, and the way the managers monitor the entities they invest in on behalf of the pension fund. This may influence what is invested in, and how this is done. It will also have an effect on mandating and the way the benchmark is chosen.

The purpose of this paper is to provide decision makers in pension fund boards and pension fund executive offices a concrete framework to select and implement mandates in such a way that long-term investing elements with expected positive payoffs are enforced, as well as negative ones mitigated. In doing so, we build on a common framework for the selection and monitoring of mandates as recommended by the Dutch Central Bank. We also build on initiatives such as the 'Model Mandate Initiative' of the International Corporate Governance Network (2012), Focusing Capital on the Long Term (2017) or the 300 Club (Dijkstra and Van Dam, 2018). This paper will answer the following questions: What is long-term investing? Why is it important for a pension fund? How does sustainability and long-term investing fit within the policy cycle of the pension fund? What concrete steps can I take within the pension fund?

While creating the paper, we have spoken with several pension fund trustees and chief investment officers of investment management organizations, who provided many valuable concrete and applicable examples. In this paper we have chosen to use the experience and approach of one pension fund, the Dutch pension fund for the Railways (Spoorweg Pensioenfonds), as an example to illustrate the effect of a long-term investment policy on the entire policy cycle.

2. What is long-term investing?

The concept of long-term investing has been around for several decades. Seminal studies emphasize that investors with a longer investment horizon are able to earn risk premiums not accessible to investors with a shorter horizon (see for example Graham, 2005, Haugen, 2009, Ang and Kjaer, 2012, or Ellis, 2013). However, this requires a disciplined investment process and clear view on what risk premiums are to be earned and how. Despite the commonalities, there is confusion about a proper definition of long-term investing. As a working definition, we suggest that long-term investing concerns harvesting long-term risk and return sources in a way that investments are not chosen and held with the expectation that they can be used to achieve an above average return in the short term, but with the expectation that this will be the case in the long term. To that end, the investment style stimulates the long-term behaviour of the entities in which it invests.

Long-term investing can subsequently be seen from various perspectives. It helps to differentiate between 1) the holding period and the investment horizon, 2) liquid and illiquid investments, and 3) the overlap between long term investing and sustainability.

First, it is important to distinguish between the *holding period* of an investment, and its *horizon*. An equity position can be held in various ways, in most extreme opposite ways: by buying a (limited) number of equities and holding these for the entire period, or through an index fund where the underlying shares are changed once per year or more often. The *holding period* is shorter in the latter case, but the *time horizon* of the investment is not. A pension board can therefore have a long-term horizon and support this with a long-term analysis but implement it with equities with a short *holding period*. On the other hand, an index investor has no outlook on the long-term potential of an individual company but could coincidentally be a long-term shareholder of that company. The composition of the index depends on the choice that the index provider has made when constructing the benchmark, and when a pension fund adopts a passive investment strategy, the holding period is the choice of the benchmark provider (see also De Roon and Slager, 2012). On the other hand, it is not true that an engaged investor is automatically a long-term investor, as he could decide to sell off his investment in the short run (e.g. within a quarter or a year) if his return rate decreases or the return objective has been met.

In other words, whether you are an active or passive investor says nothing about the long-term character of those investments. It is about the effects the pension funds' investments and investment decisions have on the entities in which is invested. It is important, for both active and passive investment styles, what kind of engagement in selection and monitoring is intended, and that the board is aware of the possible (un)intended consequences of such decisions and manages such consequences.

A second distinction needs to be made for liquid and illiquid investments. For liquid investments, like the example above, the fund can make a clearly different choice between the holding period and the horizon. That is different for illiquid investments; an infrastructure mandate is usually construed for a period of 10 to 15 years, in order to achieve the extra investment returns needed to compensate for the illiquidity of the underlying investment. The board cannot have a different horizon than the holding period in that case, or it will risk terminating or selling the mandate at a discount.

A third distinction is that a long-term horizon cannot be equated to sustainable investing and/or applying ESG ('environmental, social and governance') factors. For example, 15-year government bonds are clearly long-term, but are not seen as sustainable investments. On the other hand, an underlying equity such as Unilever may have a clearly positive sustainability impact, and may have been bought for that reason, but the pension fund might act as a shareholder with a pure short horizon, once the intended profit goal has been achieved. Nonetheless, sustainability and long-term investing are often connected in practice. Companies leading the way in sustainability might perform worse in the short term, but they often do better in the long term, and certainly have a better risk profile (Demmers, 2017). Therefore, in case it holds true that energy transition and sustainability significantly change the economy in the coming years, the sustainability performance of companies will increasingly be considered in the analyses and valuations made by asset managers. These better financial performances do often require a somewhat longer investment horizon to earn and might not be realized to its fullest potential with an investment approach that is too focused on the short term.

In short, long-term investing is about harvesting long-term risk and return sources, the effects of the investments on the short or long-term behaviour of the entities being invested in, and the subsequent desired effect that has on the long-term risks and returns of the investor.

3. Why choose long-term investing?

Pension funds are long-term investors par excellence because of their 50+ year liabilities and commitments. It does not matter if the underlying pension scheme is defined benefit (DB) or defined contribution (DC). For all pension schemes, the pension fund needs to generate investment results to fulfil the long-term pension commitments. For pension funds, that long-term horizon is both a natural advantage in comparison to other financial institutions, as well as a bitter requirement, especially in the current economic climate of low return expectations, where a limited extra return can quickly make the difference between cutting or indexing pension benefits. Because of their long commitments, pension funds can hold more illiquid investments. That offers them the opportunity to earn an illiquidity premium, thereby gaining a higher return.

In literature and discussions, developing a long-term investment framework suggests the following advantages. First, it helps to focus on the long-term cash flows that matter to the valuation of the company, especially in combination with ESG factors. Second, long-term investing supports investments that might be unattractive in the short term but valuable for the long term. Third, monitoring and selection costs drop: the likelihood that mandates will be switched decreases, avoiding transaction costs, while the investment manager can spend more time to monitor the investment in depth due to the longer horizon.

A recent insight is that the use of ESG data in the investment decision can at least reduce the risks of the investment and thereby reducing the risks of earning the expected risk premiums. For example, a company that has to make significant investments to reduce carbon dioxide emissions might run up costs in the short term, though with an uncertain but expectedly positive outcome in the long term. If the company has shareholders with a short-term horizon, emphasis will be consciously (through pressure by the shareholders) or unconsciously (in the perception of the company's management, or through comparison with other companies) put on stable cash flows in the short term, creating an incentive to tone down investments to reduce emissions. However, in this example, emphasis on stabilizing short term cash flows might increase the uncertainty of the future cash flows even more. The development in the short term is thereby given priority over value creation in the long run.

Markets are not so efficient that the sum of short-term results is equal to the possible long-term results. An excessive focus on the short-term means missing out on chances for additional returns found in the long term, and which only few investors could harvest. Think of investments in fundamental innovations, which have both a long investment period and a high economic value.

By utilising ESG data it is also positive to achieve more positive societal impact with the investments, e.g. through a focus on the Sustainable Development Goals (SDGs). Something that many participants in pension funds can value beside achieving financial returns. Contrarily: a pension in a world with disastrous climate change, mass migration flows or famine is worth less, too.

A less visible, though equally important factor is that a properly designed long-term investment policy, as we will discuss later, also requires a more long-term oriented relation with the asset manager. This offers room for cost savings and increases the number of investment strategies (capacity wise) that could be employed by the pension fund. Changing asset managers is a costly affair. As the investment sector gets more knowledge intensive and more people are employed, potential active returns, a major reason for hiring and firing, will decrease over time (Ellis, 2014). A study of American institutional investors (Busse et al., 2010) shows, for example, that new external mangers are often hired after showing a period of high positive added value (the 'outperformance' as compared to the benchmark). However, this outperformance disappears after hiring the new external manager; the fired manager, in his turn, is showing extra performance again. The researchers estimate that the foregone returns caused by firing and selection, as well as opportunity and transaction costs, can accrue up to 5 to 10% return for an investment mandate. If institutional investors base their decisions to hire or fire managers mainly on realised performance, the difference turns out to be even bigger. Because selection and monitoring processes provide increasingly more standardised comparisons and rankings, there is a risk of 'performance chasing' and action bias. When an investment committee or a board conducts an evaluation process, without a proper long-term policy framework and governance structure, it will decide to change the mandate too soon and too often, as it might otherwise come off as indecisive.

Selection costs might decrease when the mandate gets a longer horizon; monitoring costs however will not necessarily fall but change in nature. A long-term relationship with the asset manager offers the pension fund board and pension agency the possibility to put less focus on the default monitoring agreements, and to put more time and resources in a relationship where the board is informed sooner about new developments that are relevant, but which might not clearly fit within the information requirements of an investment management agreement or service level agreement.

4. Long-term in the policy cycle

Each investment that a pension fund does, and each mandate that a board issues, must fulfil the same quality requirements and process steps. This is no different for long-term mandates. Deciding on policy, selection, governance, monitoring and evaluation form the most important steps in the investment process. Using this process, we describe if - and if yes, which – adjustments or choices have to take place to support the long-term investment results. For illustration purposes, we provide the examples for Dutch SPF Pension Fund for each of the steps in the boxes.

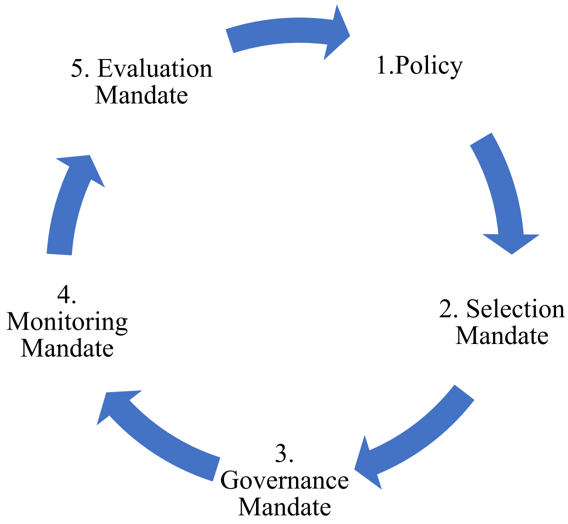

Figure 1: The Selection and Monitoring Process (Source: De Nederlandsche Bank, 2014)

4.1 Step 1 - Formulating policy

Pension funds that make successful long-term investments start with the 'why' question. Their investment beliefs open the door for long-term investing, followed by "the regular steps" in the selection and monitoring process. Setting its investment beliefs, the board agrees on what principles they do find important in the establishment and design of investments. This framework is leading for all subsequent choices. For long-term investing, it is essential that long-term investing makes up part of the investment convictions. The board must figure out the *why* of long-term investing and share an explicit investment conviction on long-term investing.

For a pension fund board, it is worthwhile to agree on a shared definition and rationale that fits the fund's characteristics and guides the subsequent implementation. The following three stylized beliefs are examples of commonly used beliefs in board discussions.

Stylized Principle/Belief 1: As a pension fund, we have long-term obligations. That offers us the opportunity to realise risk premiums that can only be cashed in the long term.

Stylized Principle/Belief 2: We focus on risk premiums, which can only be earned with a long-term horizon.

Stylized Principle/Belief 3: As a long-term investor, we have an interest in long-term value creation and acting as engaged shareholder. We help companies we invest in to focus more on sustainability. We assume that this will also mean better investment performance in the long run.

These three different beliefs have in common that they focus on risk premiums. A subsequent discussion is then to identify which risk premiums are relevant:

- Risk premiums of existing markets. Think of equity risk premiums, corporate bond risk premiums or the risk premium that results from the term structure of fixed-rate securities. A clear example is the illiquidity premium for non-listed assets. Furthermore, it might be argued that a longer-term horizon is necessary to acquire most factor premiums.

- Risk premiums for markets that are incomplete or emerging. These risk premiums are often a combination of individual markets/investments we already know. The combination is new, however. The premium is likely, but it lacks strong evidence, otherwise it would be an existing market that everyone was already investing in. An example is healthcare real estate. This partly concerns the well-known real estate characteristics, and partly concerns the known loan characteristics in the healthcare sector. The only new part is that both are combined.

- Risk premiums that we do not know yet. This involves markets that did not exist before, with new characteristics. Now historic examples are emerging markets investing, structured credit or commodities investing.

Sustainable and ESG investments often fall under risk premiums for incomplete or emerging markets, or markets that we do not (fully) know yet.

Box 1 provides examples of investment beliefs and principles of various Dutch pension funds. For the discussion of the following steps, Spoorweg Pension Fund will be used to illustrate how long-term investing is embedded in the investment cycle.

Pension Fund Vervoer (Transport Pension Fund):

“Those accruing pension in the Transport Pension Fund are young, on average. That means that we can invest the capital for a long time before it is time to pay out. Those who can invest long term have more investment opportunities, and more chance of good returns. This means that we will be able to actually pay out the amount on the UPO, with greater certainty. Unfortunately, we cannot offer 100% certainty. But we maximally leverage our strength as a long-term investor.”

PFZW (Pension Fund Healthcare) Investment Policy 2020:

"PFZW is gradually turning into a long-term investor making its own choices, and less of an investor that lets itself be led by benchmarks." ... "To realise the pension ambition, now and in the future, we must carefully handle the ingredients of return that will become scarce in the long run, such as raw materials, capital and people. ... By doing so, we give meaning - over the breadth of the portfolio - to our belief that a durable, sustainable world is required to be able to generate enough returns in the long run, and that considering sustainability aspects will be rewarding in the long term."

Spoorweg Pensioenfonds (Railway Pension Fund):

SPF recorded long-term investing in its investment principles: five of its ten investment principles consider the long term. The following three investment principles illustrate long-term thinking most clearly:

"Investment principle 1: There is a premium for illiquidity and investing in the long term.

Rationale provided by the board:

- SPF is a long-term investor and is therefore capable of earning additional sources of return, which are hard to utilise for other investors.
- These sources make it possible to generate a premium by investing in illiquidity; by following a non-cyclical investment policy and by holding investments for a long period.
- The measure in which the fund can invest in illiquid sources is determined by the structure of the obligations.

This means, or is the basis for:

- Use illiquidity by investing in illiquid categories, such as real estate, mortgages and private equity funds.
- Use investing in the long term by rebalancing the portfolio based on bandwidths. By doing so, relatively high-valued investments are sold, and relatively low-valued investments are bought.
- By doing so, we accept that there will be short-term fluctuations in the coverage ratio.

Investment principle 2: Valuations return to their long-term average.

The economic and financial markets follow long-term trends, and medium/short term cycles. Breaks in the trends happen, but they are rare. Realistic growth, profits and valuations/risk premiums fluctuate around these trends and tend towards long-term averages. Beliefs in trends and long-term average valuations helps to focus on the long term and avoids panic reactions in the short term.

Investment principle 3: Sustainable and responsible investing can be done without harming the return-risk profile of the portfolio.

Rationale provided by the board:

- As an investor, SPF has a larger impact and responsibility than simply realising a good return-risk for its participants.
- Socially responsible investing (SRI) adds value because it creates a framework that can be used to identify investment themes for long-term use, and which therefore fit well with SPF's investment horizon.
- SRI helps to identify investment themes with downward risks in the long term. It enables us to mitigate these risks and to invest in a sustainable and stable world.

This means, or is the basis for:

- The socially responsible investing done by SPF is shaped through acting as engaged shareholder and through risk management, e.g. by engaging with companies and voting at their shareholders meetings.
- We explain to our participants how our choices to invest sustainably and responsibly fit with the preferences of the participants, and SPF's ambitions. We also explain how sustainable and responsible investing is an integral part of the investment process."

Box 1. Examples of investment beliefs and principles on long-term investing of Dutch pension funds

4.2 Step 2 - Designing the mandate and selecting the asset manager

As a next step, the framework of the mandate is designed which can then be used to select an asset manager. This step typically consists of developing an investment case and investment guidelines (which could both be part of one decision document). The investment case describes "why" a certain investment category should be included in the portfolio:

- What risk premium does the fund expect to earn over what period? When is it expected that the risk premium will or will not materialise?

- How is this supported? Has a lot of research gone into this, or is it limited? In other words, what is the evidence-based level of conviction?
- What are other managerial considerations that should be considered for this investment category?
- Is the investment category consistent with the investment convictions set by the fund?

For example, if the investment case for a long-term equity strategy is developed, the investment case will be used to answer the question if the development of such a strategy, compared to other equity-based investment styles, earns a similar positive equity risk premium. This requires research. It will also become clear in such an investment case that the portfolio will deviate from all benchmarks, because the equity shares are held for a long period of time. However, if this investment category is seen in conjunction with the total portfolio, the benefits (low costs, expected positive risk premium, better connection to commitments/liabilities) can be more beneficial than possible disadvantages (the tracking error). Finally, the investment case indicates the horizon the board should be thinking in. To put it bluntly, a long-term, value-driven strategy cannot take place over a period shorter than 10 to 15 years and the board should commit to this choice.

Where the investment case is set in abstract terms, the investment guidelines then describes the concrete framework for selecting an asset manager and mandate. The guidelines that are set are, amongst other things, the quantitative objectives as well as qualitative ‘spirit’ of the mandate, the benchmark, investment restrictions and the investment form that best gives shape to the mandate such as internally vs. externally managed mandate, type of investment vehicle, etc.).

Once the investment guidelines are defined, the actual selection and development of a long-term mandate can take place. The following points are important to consider:

- What are good criteria to maximise the chance that the long-term promises are honoured? A pension fund board wants to be comfortable about the long-term focus of the asset manager beforehand. Beside the long-term mandate, the asset manager may have numerous other mandates or products, and will have objectives regarding profitability, revenue growth or solvency. These may cross the intended long-term policy of the long-term mandate. How do you look at this as a fund? Which (shared) criteria and principles are important? The story of the asset manager may be perfect; the setting in which it operates does not have to be.

- Work out how you want to shape the collaboration relationship, and what does that mean for the selection process? For example, should the duration of the mandate be equal to the duration of the contract with the asset manager? This does not need to be the case; the fund could fire the asset manager at a certain point in time and appoint another but keep the portfolio equal. This would imply that the relationship concerns both the mandate and the asset manager; it is important to be aware of this.

- How does the manager shape its engagement policy, how does it exercise influence, and how does it integrate ESG and long-term considerations?
- What is the risk/return requirement that the board wants to apply to the mandate? Is that an absolute return? Can a benchmark be found for it, or do multiple benchmarks apply?

In 2010 pension Dutch pension provider SPF launched a Strategic Equity Portfolio on behalf of the railway and transport pension funds SPF and SPOV. The Strategic Equity Portfolio was launched in 2010 and forms about 55% of the total equity portfolio of SPF end 2018.

The reason to launch the Strategic Equity Portfolio after the financial crisis of 2008 was the realisation that the relative performance (positive alpha) of a mandate/fund might be positive, which contrasts with substantial losses in value due to market movements (negative beta). The pension fund board wanted to design a concentrated equity mandate that would achieve positive absolute returns in the long term. In shaping the mandate, sustainable investing was gradually embedded, which as it turned out to fit well with the approach. The goal was to achieve returns that consisted of the 10-year swap rate plus an equity risk premium of 3%; in short, a (regular) benchmark agnostic portfolio. Together with SPF Beheer, the pension fund board developed the Strategic Equity Portfolio where a horizon of seven years was set for its evaluation. The portfolio was composed bottom-up, from a number of stable companies with regard to revenue, profit and dividend. Three regions are distinguished (US, Europe, other developed markets), but no stringent region weights were imposed from the start, with a 'reasonable' spread over different sectors.

A concentrated portfolio of 60-80 equities was constructed. The manager was not given a tracking error limit. However, there is an implicit tracking error, because the total equity portfolio has a tracking error limit. This shows that the pension fund board integrally focuses on the entire portfolio and the long term (see step 4 and 5).

Box 2. Designing the mandate: the Strategic Equity Portfolio of SPF.

4.3. Step 3 - Governance of the mandate

Designing the mandates formalise the governance of the investment process. In this role, the asset manager is the contractor. For him, the mandate is a concrete implementation assignment that needs to be realised. When setting up the mandate, the following components, which could positively the long-term focus, are important to the governance of the mandate:

- Explicit agreements to first discuss what investment horizon fits the risk/return profile and what it implies for the way the portfolio is monitored and evaluated.
- Aligning the fees with the long-term strategy. Ideally, the manager is not rewarded for market movements effects, but rewarded for investment choices that fit within, and add value to the long-term investing strategy. For well-known strategies and risk premiums: fixed rewards and compensation are more logical. For lesser known strategies and newly developed risk premiums performance fees might be considered, as they come with a higher degree of uncertainty.
- Define the mandate in such a way that it is implementable but not so rigid that the mandate must be adjusted in case of changes in the financial markets.
- The way in which ESG factors are an integral part of the investment process of the asset manager, including decision-making and reports.
- A check to see whether the mandate is a consistent translation of - or fits within - the investment beliefs of the fund.
- Metrics for monitoring and evaluation: benchmark, evaluation horizon, evaluation method, when to go from monitoring to evaluation.

The benchmark deserves special attention concerning the governance of the mandate. It is important to agree upfront what the role of the benchmark is in the monitoring and evaluation of the mandate. The benchmark must especially – from a principal agent problem – provide the board with insight into whether the manager is making consistent choices within the strategy. This might imply that there may be multiple benchmarks for the mandate: multiple benchmarks for different goals ("horses for courses").

- Benchmarking compares the mandate with other mandates, to learn from one another. The goal of benchmarking should not be dealing with an individual manager, but rather improving the performance of the entire pension fund. Another goal is the transparency that is offered to participants of the fund.
- The benchmark should answer the question: what is the systematic interest/risk reward that I as a fund would get with similar investments?
- The benchmark must be constructed in such a manner that, if there is a difference between the benchmark and performance of the mandate, there will be concrete feedback information that the manager and the board can use to learn from. If the difference arises through accounting (think of different discounting curves, other times of processing information, etc.), the benchmark should not be applied.
- The benchmark will be a "problem" if you did not think your beliefs through at the beginning. For example, if you write down 'passive except' in your investment beliefs while in the mandate the

board states that it aims to be an involved long-term investor with buy-and-hold, things will not go well. However, if you write down that your principle is that holding good companies in the long term are the best foundation for good long-term returns, the deviation from the benchmark, such as for example the tracking error in the medium run, would be a logical consequence. This then means that the distinction between active/passive becomes less relevant.

4.4 Step 4 - Monitoring

The longer the investment chain, i.e. the more decision and delegation steps between board and ultimate portfolio manager, the trickier it is to consistently implement long-term investment strategies. The further the final investment is removed from the pension fund board, the greater the risk that behaviour and stimuli in the investment chain will stimulate more short-term actions. It starts with the pension fund board. In order to truly implement long-term investing, it is essential that the pension fund board focuses on this. The board must be continuously focused on the long-term results it wants to achieve, and how it will act with intermediate results. Ideally, the board has agreed or laid down in advance how it *wants* to deal with interim results in specific mandates. How to employ and use benchmarks must explicitly be part of the board monitoring process and framework. Mutual trust and consistent behaviour are key words in this governance relationship.

For a long-term mandate, the pension fund discusses the following issues beforehand with the asset manager. First, there must be clarity about the horizon. It is important that the reporting for the monitoring has set the applicable horizon in advance. Is this an investment style that should be assessed for at least 5, 10 or 15 years? For example, if the investment horizon is e10 years, the board could commit itself to these 10 years and this should be reflected and reiterated in dashboards and reports. Being explicit about this within the governance of the mandate helps the board prevent taking decisions with unintended consequences in the short term. Think, for example, of:

- Equity risk premium: 6-8 years, may be longer, depending on the investment style,
- Credit risk premium: 5-7 years,
- Illiquidity premium real estate: 8-10 years,
- Illiquidity premium private equity: 15+ years and investing throughout the cycle, because a part is allocated every year,
- Frontier market: 25 years.

Besides setting the investment horizon from the start, there must also be clarity about the behavioural risks of the board that might affect the horizon. If the fund first performs very negatively and subsequently positively across the entire horizon, this will be experienced quite differently from a positive start with a negative performance across the entire horizon. How do you deal with that? What should you certainly not do? This can be part of a “pre-mortem”.

Creating the right balance between qualitative and quantitative factors improves the quality of monitoring. Quantitative numbers form an important part of monitoring, but what qualitative factors are incorporated? Investment return, risk and costs are the most used standards, within a framework that systematically evaluates organisation, team, process and performance (De Kreij, 2018). Cash flows, earnings growth, dividends and qualitative factors such as commitment to sustainability goals or consistency of long-term strategy or the board structure of the companies which is invested in, are factors that fit better with long-term investing.

Finally, what monitoring ‘style’ does the board opt for? It needs to be decided how monitoring takes place, beforehand. Does the board choose for monitoring by exception? If the board agrees on a tracking error of 2% compared to the benchmark, all results within +4% and -4% compared to the benchmark should not be the reason to discuss or evaluate the mandate. After all, this is a consequence of a tracking error. The board or committee only wishes to discuss results if the performance deviation is statistically significant, or if there is persistent outperformance or underperformance over a longer period of time. Finally, the monitoring frequency is not very important, as long as it is clear what constitutes monitoring, and what constitutes evaluation.

A 7-year horizon was set for the Strategic Equity Portfolio. The benchmark and tracking error are also clearly defined at the total portfolio level. The mandate was developed and created in conjunction with the manager. Once per year, the Strategic Equity Portfolio managers discuss the portfolio and developments in the investment committee meeting of the pension fund board. Once per year, an evaluation is held within the pension fund board. The board receives quarterly reports. New board members within the pension fund board are actively involved in the characteristics and goals of the Strategic Equity Portfolio, amongst others by walking around at the investment office and getting to know the various investment team members and their alignment to the strategy.

Box 3. Monitoring of the Strategic Equity Portfolio of SPF

Step 5 - Evaluation

When do you move from monitoring to evaluation? And how do you prevent that monitoring is more like evaluation than monitoring in practice? For long-term investing, it is very important to distinguish between these definitions and elements of the policy cycle. For many boards, the most important criterion in the evaluation is still the performance numbers over the short term, even though they contain more noise than information. Better conclusions may be drawn if the performance is considered from multiple angles, and when it is clear how it came to be. Key elements for a thorough evaluation might include:

- A shared understanding what is to be evaluated. Is it the investment case? Will the investment framework or mandate be discussed? Or is it the performance of the asset manager? These are different topics leading to different types of evaluations.
- A shared understanding of the horizon to evaluate the strategy. For example, a period of eight years can provide insight for a passive listed equity strategy. However, an illiquid private equity strategy requires a much longer period for a proper evaluation.
- A shared understanding that continuing the strategy is the base case scenario for the evaluation. This helps to prevent action bias from the board or the investment committee.
- A shared understanding how to avoid preventable surprises and make this part of your evaluation. For example, conducting a pre-mortem exercise is a useful board room tool, which entails identifying potential problems and taking mitigating measures beforehand. In the late 90s, real estate investments, hedge funds and private equity were considered to be long term strategies and incorporated in many institutional portfolios, based on the argument that a long-term risk premium would exist that could not be earned by other investors. Many pension funds then sold-off these investments again within ten years. To prevent this from happening again, the board should determine at the start of the investment when the investment or mandate may come "under pressure". Is the choice strongly propagated by a few members of the board or the entire board? What if the board would be completely new in five years, would this investment then still be seen as a sensible choice?

The evaluation of the Strategic Equity Portfolio takes place based on a long-term absolute benchmark, the targeted return (10-year swap rate plus 3% equity risk premium), and a relative benchmark (MSCI Quality Developed Markets). Over the investment cycle of this mandate a formal evaluation took place twice (in a duration of 11 years). Looking towards the future, the evaluation will take place every three years. The evaluation is focused both on the quantitative as well as the qualitative key measures.

Box 4. Evaluation of the SPF Mandate

5. What steps can I take with my pension fund now?

Pension funds are increasingly trying to embed long-term investing choices within their portfolios. Based on a practical framework, we have argued that long-term investing strategies can be implemented within the regular investment cycle of pension funds. What steps can your pension fund take today?

1. Develop a shared vision on long-term investing that is carried by the whole board, and document it in the investment beliefs. In case some of the board members still have doubts, it is important to take more time to get strong support for the strategic choice.
2. Ensure that new board members subscribe to the principles, investments beliefs and approach concerning long-term investing before they are appointed, and not afterwards.
3. Discuss the consequences that the long-term investment beliefs have for the implementation of the investment policy.
4. Design reports in such a manner that as a board you discuss the right topics. Start with the qualitative monitoring criteria for the portfolio, and not the investment returns of the previous month. Show the intended horizon for the strategy in the reports by default.
5. Ensure that the manager fully utilizes the long-term horizon. Challenge the manager how he or she is planning to make optimal use of this, as well as which ESG themes are addressed within this horizon as well.
6. Be clear about the role of the benchmark. Is this the starting point for a discussion, is it the main investment objective, or does the pension fund see a different role for it?
7. Choose risk measure that are relevant to the long-term horizon of the mandate. For example, do the companies in the portfolio have stable outlooks, what about increasing debt ratios? Indicate what quantitative risk measures actually entail. Is there a function for the ex-post tracking error?
8. Make a clear distinction between monitoring and evaluation, and act accordingly.
9. Develop a pre-mortem, by identifying potential problems and taking mitigating measures beforehand. The board should determine at the start of the investment when the investment or mandate may come "under pressure". Is the choice strongly propagated by a few members of the board or the entire board? What if the board would be completely new in five years, would this investment then still be seen as a sensible choice?
10. Develop a “board check” for long-term investing, to determine if the board members are capable in long-term investing. If this board check does not lead to the desired results, the board members should first think it through more, or accept that they will not be doing it.

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